State-owned Enterprise

The Story So Far

Reforming state-owned enterprises (SOEs) is critical to improve the competitive environment within China’s economy and in overseas markets where Chinese firms are engaged in trade and investment. Unlike other commercial entities, SOEs are tasked with economic and political objectives. The crux of SOE reform is delineating and separating these commercial and political activities.

During the 1990s, Beijing tried to reform the state sector by consolidating state control over large SOEs while withdrawing from small ones, which contributed to private sector prosperity and a decade of strong economic growth. In the 2000s, Beijing redefined SOE “reform” as concentrating state control over key and pillar industries with strategic linkages to China’s economic development and national security.

In 2013, the Third Plenum further clarified SOE reform as transforming SOEs into modern corporations, with the state exercising influence in the same fashion as other shareholders. The Third Plenum also envisioned that the state would reduce control of commercial SOEs while pushing SOEs in strategic industries to focus on their “core” business areas.

- Starting in 2014, Beijing tried to improve SOEs’ competitiveness using ad hoc measures, such as mergers and mixed ownership programs (similar to those used in the 1990s) involving the sale of minority shares to private firms. These piecemeal efforts continue today. However, none of these measures has been sufficient to reshape SOEs’ incentives in line with market principles or redefine their role within the economy.

- In September 2015, the State Council published a new set of “guiding principles” for SOE reform. The document was more conservative than expected. Rather than allowing the market to decide the future of SOEs, the State Council proposed utilizing market mechanisms to make SOEs bigger, stronger, and more efficient, while maintaining control by the government.

- The 2015 guiding principles reiterated a 2013 Third Plenum goal to transform the government’s role in managing SOEs from “managing assets” to “managing capital.” The plan was to allocate state capital toward strategic industries and reduce direct intervention within SOEs’ day-to-day operations, thereby improving efficiency. The government also stated that it would strengthen SOE corporate governance but made clear that it viewed Communist Party supervision as critically important.

- Since 2017, the government has pushed to “corporatize” SOEs, including establishing boards of directors to replicate the structures of other commercial entities. But it also required all SOEs to institutionalize the role of Communist Party committees into their articles of association and give the Party oversight for all strategic decisions. As a result, boards of directors still lack de facto authority to manage SOE operations.

Methodology

We use China’s own classification scheme to assess SOE reform progress. When information is available for listed companies, we gauge SOE revenue relative to all revenue in three clusters: (1) key industries (defense, electricity, oil & gas, telecom, coal, shipping, aviation, and rail); (2) pillar industries (autos, chemicals, construction, electronics, equipment manufacturing, nonferrous metals, prospecting, steel, and technology); and (3) normal industries (tourism, real estate, general manufacturing, agriculture, pharmaceuticals, investment, professional services, and general trade). As SOE reforms are implemented, the state firms’ share of revenue should at a minimum decline in normal industries – those that Beijing has identified as suitable to market competition as the decisive factor. To supplement this primary indicator, we look at the share of all industrial assets held by SOEs, leverage ratios at state versus private firms, SOE versus private returns on assets, SOE versus private ability to cover interest payments, and the SOE share of urban employment.

Quarterly Assessment and Outlook

Primary Indicator: Share of SOE Revenues in Different Industry Categories

- Our assessment is unchanged: state-owned enterprise (SOE) reform did not advance despite superficial policy
developments. SOE revenue share in “normal” industries remains higher than 2018 average despite a minor decline this quarter.

- Private firms outgrew SOEs this quarter thanks to improved credit conditions, but the trend may reverse by year-end. Meanwhile, SOEs and private firms both saw worsening profitability as reform stalled.

- Policy developments in the review period generated a positive buzz in the headlines but as a practical matter have not yet reduced state control of SOEs or the economy.

This Quarter’s numbers

Our data show no net progress in SOE reform this quarter. In “normal” industries – those identified as non-strategic and from which Beijing pledged to withdraw state influence – SOE revenue share among listed firms decreased to 15.9% in 2Q2019 from 16.4% in 1Q2019 (see The State’s Share of the Take). This is a welcome move but is too minor to constitute reform: SOE revenue share in normal industries remains above the 2018 average. The change was primarily due to faster revenue growth among private firms than SOEs in the real estate sector, likely because private developers under financial stress were more aggressive in selling property units. Private firms also generated more revenue than SOEs in professional services, especially in areas related to information technology and advanced manufacturing.

At the same time, SOE revenue shares in “key” and “pillar” industries rose. SOE revenue share increased slightly to 84.5% in 2Q2019 in key industries that Beijing identifies as strategic to China’s national security and intends to exercise control. In pillar industries considered strategic to China’s economic development, SOE revenue share also increased to 45% despite talk of Beijing giving markets a larger role in these industries. More than 70% of A-share (Chinese stock market) listed company revenue is SOE revenue: that is the reality of state presence.

Private firms expanded faster than SOEs this quarter, but the trend may not last long. Total assets held by industrial private firms increased by 5% from 1Q2019 to 2Q2019 – more than the 2% gain for SOEs – causing SOE industrial sector presence to decline slightly (see Industrial Assets by Ownership). Improved credit conditions drove the expansion in private assets; however, credit growth is likely to slow in the second half of the year as lenders start to better price credit risks, meaning they will reduce borrowing to riskier private companies (see Financial System cluster). Over the next year, private firms may once again lose out to SOEs due to changing credit conditions.

Despite improved credit growth, all firms were less efficient this quarter. Returns on SOE assets slipped to 3.9% in 2Q2019 from 4.0% in 1Q2019, and for private firms returns fell to 6.8% from 7.1% (see SOE Return on Assets). This drove slight deterioration in the interest coverage ratio for SOEs and private firms to 4.3 and 4.4, respectively (see SOE Interest Coverage Ratio). Only serious reform can revive profitability of both SOEs and private firms. Without it, no amount of new borrowing will enable firms to comfortably service debts.

Supplemental 1: Industrial Assets by Ownership

percent

Supplemental 2: SOE Leverage

12mma, percent

Supplemental 3: Return on Assets

Percent


Supplemental 4: SOE Interest Coverage Ratio

Profit to interest ratio, 12mma

Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment

Percent

Source: Ministry of Human Resources and Social Security, Rhodium Group.

Policy Analysis

SOE policies in the review period point to superficial reforms without relaxation of state control over the economy. On July 31, the Small Leading Group (SLG) on SOE reform announced the interim results of the “double-hundred actions” campaign. Since its August 2018 initiation, the campaign has focused on implementing mixed ownership and corporate governance reform in more than 400 central and local pilot SOEs by 2020. If faithfully implemented, this campaign would reduce state control in pilot firms and discipline state influence over their commercial decisions. But neither has been the case so far.

According to the SOE Reform SLG, under the campaign one-quarter of pilot SOEs have diversified their shareholding structure, one-third have attracted private capital into group companies, and more than half have attracted private capital into their subsidiaries. Together, pilot SOEs have completed around 30% of reform tasks and attracted 538 billion yuan ($77 billion) in private capital. This seemingly positive progress is inconsistent with our primary indicator: the campaign included 61 listed companies, but our indicator picked up ownership changes in only a few SOEs, with no meaningful change in SOE presence in the economy. One explanation is that the pilots did not sell large enough stakes, keeping the state as controlling shareholder. If that is the case, the campaign is not successfully reducing state control over pilot enterprises but rather bringing more private capital under state control.

State control over private-invested SOEs would not be so problematic if there were a proper governance structure in place to discipline state influence over the firms’ commercial decisions. The SOE Reform SLG claimed progress in this area: 77% of pilot SOEs have established boards of directors, and 94 of 221 (43%) solely owned SOEs have appointed enough external directors that they now account for more than half of board members. Central SOEs and local governments have also delegated more power to boards of directors and recruited more managers from the market. However, these improvements are likely inadequate to bind SOEs to market principles as they fail to address one fundamental problem: SOE leaders are still government officials subject to state evaluation; therefore, they are more likely to prioritize political objectives over commercial ones compared with private firm leaders.

One positive development is that SOEs are being asked to pay their due on social security. On September 20, the Ministry of Finance (MoF) set an explicit deadline – by the end of 2020 – for all large- and medium-sized central and local SOEs to transfer 10% of state equity to social security funds (as detailed in Labor Reform). The move may help address the country’s fiscal shortfall but will not help reduce state control over SOEs: the MOF intends that these obligations will be drawn from dividend payments by the SOEs, rather than by selling their equity to the public.